Bull & Bear Bulletin

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Market Rally: Recovery or Bounce?

The S&P 500 Index has rallied nearly 10% since its February low. The strong rally may lead an investor to consider whether the worst is over or if this is just a bounce within the context of a longer downtrend. To help assess the current state of the stock market, it is helpful to look at the technical picture of the market, the earnings fundamentals that support stock prices and the market's value from a historical perspective.

The technical picture for the S&P 500 Index shows a mix of positive and negative (Chart 1). From a positive perspective, the Index has recovered more than 50% of its loss from the 2015 highs; however, the Index is still well entrenched in a downtrend channel. To make the technical picture even more cloudy, the Index is currently sitting at a level that has been a key value both on the way down (when it has acted as a support level) and on the way up (when it has acted as a resistance point). A failure to move through the resistance point would establish a lower/high within the context of the trend lower and likely yield further selling, while a breakout above the key level would likely push the market towards the upper boundary of the 9-month trend channel found in Chart 1.

While the technical outlook is more "neutral", the earnings fundamentals provide better clarity. Earnings have stagnated and operating margins have declined to a three year low since the U.S. dollar started its move higher in 2014 (Chart 2). If operating margins continue to decline, companies will find it more challenging to sustain their earnings per share. Previous methods of sustaining earnings per share by companies repurchasing their own shares are likely to prove insufficient without some improvement in sales growth.

Simply looking at the valuation of the market by comparing the price value of the S&P 500 Index to its earnings per share – a ratio called price-to-earnings (P/E) – reveals that the market, despite still being 7% off its highs, is still trading near 18 times its earnings per share (Chart 3). The market can be considered slightly overvalued when looking at the current P/E. While the market was similarly valued at the start of the last bear market, there have been other periods when the market was valued significantly higher than the current levels. However, with interest rates continuing to be pushed lower from the extraordinary monetary policy being enacted across the world, valuation may be less relevant this economic cycle.

While the technical picture and the valuation of the market suggest a more balanced risk/reward relationship in the market at current levels, we have been encouraged over the past month by modest improvements in some of the key financial stress metrics we follow, such as the interest rate spread between risky and risk-free bonds and the ability for corporations to successfully issue new bonds in the market. Despite the improvements, the slower economic growth and the continual fallout from the rapid strengthening of the U.S. dollar between 2014 and 2015 remain headwinds to corporate earnings and their ability to support stock prices at their current levels; leading us to believe that the market is likely to remain either range bound for several months until earnings reaccelerate or that the market will continue to carve out a downward trend that produces additional lower/lows and lower/highs as part of a bear market.

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Valicenti Advisory Services, Inc.

400 East Water Street
Elmira, NY 14901
607-734-2665
Fax: 607-734-6845

447 East Water Street
Elmira, NY 14901
607-733-9022
Fax: 607-734-6157

24 West Market Street
Corning, NY 14830
607-936-1203
Fax: 607-936-0213

www.valicenti.com

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Chart 1

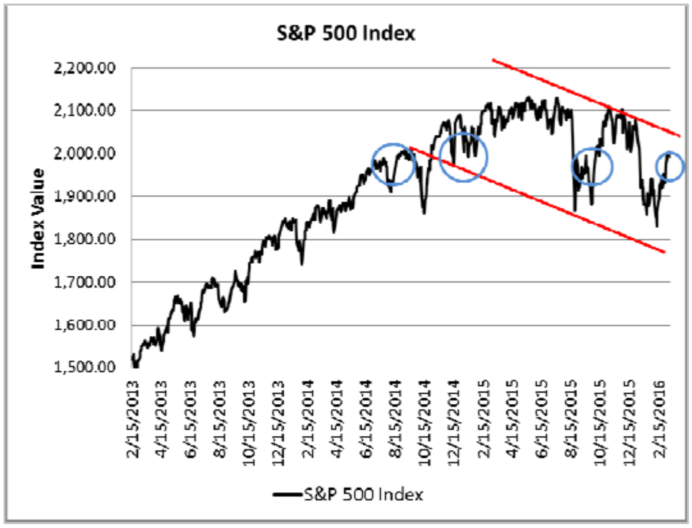


Chart 2

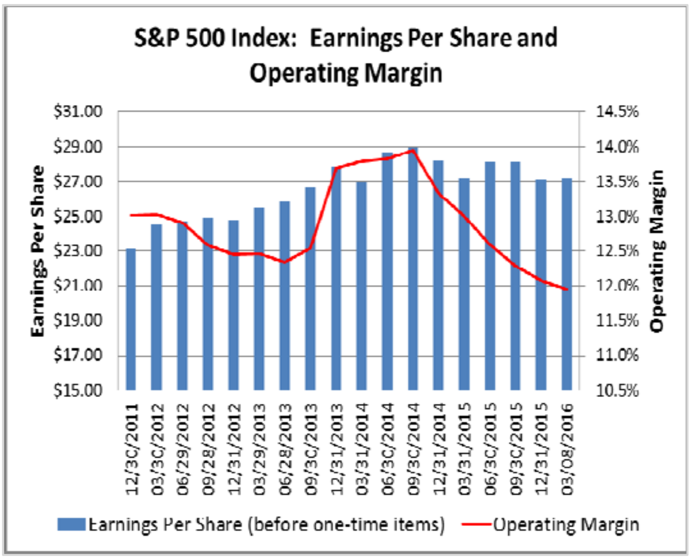
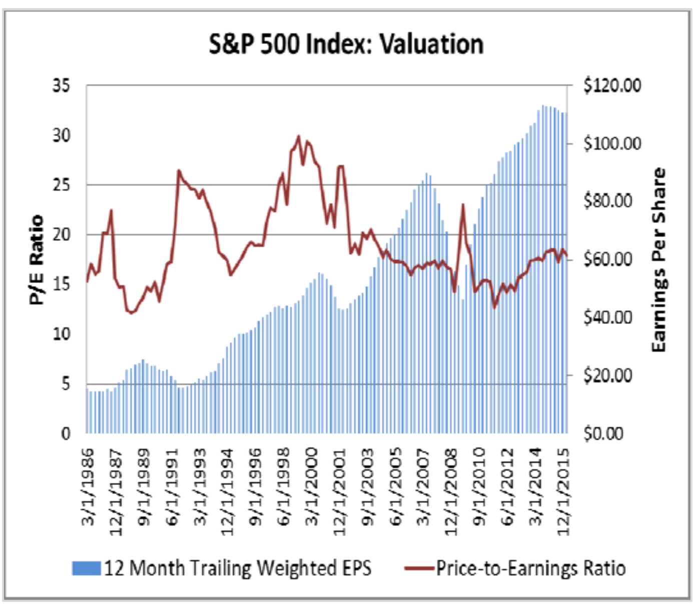


Chart 3



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